Most Taxpayers Are Advised of Their Rights Before Signing an Agreement to Extend the Assessment Statute of Limitations

September 2001

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 24, 2001

MEMORANDUM FOR COMMISSIONER ROSSOTTI

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Most Taxpayers Are Advised of Their Rights Before Signing an Agreement to Extend the Assessment Statute of Limitations

This report presents the results of our review of the Internal Revenue Service's (IRS) compliance with the IRS Restructuring and Reform Act of 1998 (RRA 98)[1] Section (§) 3461(b). This provision requires the IRS to provide taxpayers with an explanation of their rights to decline to extend the assessment statute of limitations or to request that any extension be limited to a specific period of time or to specific audit issues. We have also included additional information regarding extensions to the assessment statute of limitations.

In summary, we found that examiners properly advised taxpayers of their rights to refuse or restrict the scope of the statute extension in most of the cases (169 of 180) reviewed. However, in some cases (11 of 180 tax modules reviewed) examiners did not indicate in case files whether or not taxpayers were advised of their rights.

Management's Response: Management's response was due on September 14, 2001. As of September 19, 2001, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or

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[1] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

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Most Taxpayers Are Advised of Their Rights Before Signing an Agreement to Extend the Assessment Statute of Limitations

Background

Beginning January 1, 2000, the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98)[1] Section (§) 3461(b) required the IRS to advise taxpayers of their rights whenever requesting an extension of the statute of limitations on assessment of additional tax and penalties. In passing this law, the Congress expressed concern that taxpayers were not being adequately advised of their rights to refuse to extend the statute of limitations or to request that a statute extension be limited to a specific period of time or to specific issues. The RRA 98 also requires the Treasury Inspector General for Tax Administration (TIGTA) to provide information annually regarding the IRS' compliance with this provision.[2]

If the IRS audits a tax return and determines there is an additional tax liability, it generally must be assessed within 3 years from the date that a return was due or the date that the return was actually filed, whichever is later. This 3-year assessment statute of limitations normally cannot be extended without the taxpayer's written agreement.[3] To extend the assessment statute, the IRS asks the taxpayer to sign a statute extension agreement form (consent). A consent extends the assessment statute of limitation to either a specific period of time or an unlimited, indefinite period. The statute is usually extended for a period that both the IRS and the taxpayer agree is reasonable to complete the audit. The consent can also be negotiated to apply only to certain audit issues.

A taxpayer might agree to extend the assessment statute of limitations for the following reasons.

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[1] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

[2] Internal Revenue Code (I.R.C.) § 7803(d)(1)(C) (Supp. IV 1998).

[3] There are some exceptions to the 3-year statute of limitations. For example, I.R.C. § 6501(c)(1) (1994) extends the assessment statute indefinitely when false or fraudulent returns are filed.

- The taxpayer may want to pursue additional audit issues that are in the taxpayer's favor in offsetting a proposed tax or that might allow for a tax refund.
- If the remaining time before the statute expires is too short, the IRS may have to prematurely stop the audit process and issue a notice of deficiency that limits the time for the normal appeals process before the taxpayer must file a petition to the United States Tax Court.

There are also certain circumstances when a taxpayer may decide to limit or refuse to extend the assessment statute of limitations.

- The taxpayer may not want to provide the IRS additional time to consider additional audit issues.
- The taxpayer may not want to allow the IRS the opportunity to further develop audit issues already under consideration after the normal statute period has expired.

This report presents the results of TIGTA's second annual review of the IRS' compliance with the statute extension provisions of RRA 98 § 3461(b). In our Fiscal Year (FY) 2000 review,[4] we evaluated IRS assessment statute extensions processed from January 1 to March 24, 2000, and reported that in 192 of the 203 cases (95 percent) we reviewed, IRS examiners properly advised taxpayers of their rights to refuse or restrict the scope of the statute extension.

For this year's audit, we reviewed assessment statute extensions recorded on taxpayer accounts from April 1 to September 30, 2000. This review was performed at the following 10 randomly selected former IRS district offices: Delaware-Maryland, Gulf Coast, Houston, Indiana, Midwest, New England, North Texas, Pacific Northwest, Pennsylvania, and Southern California.

We performed the audit between January and June 2001 in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and

[4] *Information Provided to Taxpayers When Requesting Extensions of the Assessment Statute of Limitations Can Be Improved* (Reference Number 2000-10-142, dated September 2000).

methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Most Examination Case Files Indicated That Taxpayers Had Been Advised of Their Rights Regarding Assessment Statute Extensions

In order to comply with RRA 98 § 3461(b), the IRS has updated its Internal Revenue Manual (IRM)[5] to provide guidelines for IRS employees to record in the audit case file that taxpayers have been advised of their rights to refuse to extend, or to limit extensions of the assessment statute of limitations to a specific period of time or specific issues.

We reviewed a random sample of 180 tax modules which had statutes extended by taxpayer agreement to determine whether or not there was adequate documentation that taxpayers had been advised of their statute extension rights. We considered that these taxpayers were advised of their rights if any of the following documentation was found in the audit case file.

- A copy of Letter 907 (L-907), "Request to Extend Statute" or comparable cover letter, updated to include an explanation of taxpayer rights.
- A record that Extending the Tax Assessment Period (Publication 1035) was provided to the taxpayer, as indicated by the audit contact record or as shown as an enclosure on a cover letter.
- The audit contact record stated that the taxpayer was given a verbal explanation of his or her rights.

For most of the tax modules reviewed (169 of 180), examiners properly advised taxpayers of their rights to refuse or restrict the scope of the statute extension.

However, in the remaining 11 of 180 (6.1 percent)[6] tax modules, the examination case files did not contain a record that the taxpayers had been advised of their rights. As a result, for these cases, we could not determine if the IRS

[5] As revised January 1, 2000.

[6] The error rate for the sample is 6.1 percent (11 of 180); however, the results of two-stage cluster sampling must be weighted to estimate the error rate in the total population of 18,280 tax modules. The weighted error rate is 4.7 percent (See Appendix IV for additional information on how this was computed.).

protected the taxpayers' rights to be advised of their statute extension options. Although 2 of the 11 taxpayers had been advised of their rights for extension requests made prior to the effective date of the RRA 98 provisions, records of advice of rights were not maintained for additional extension requests made subsequent to the effective date of the law. Most of the cases (8 of 11) involved extensions requested by the Appeals Division. The RRA 98 § 3461(b) provides that the IRS must notify the taxpayer of his or her rights on each occasion when the taxpayer is requested to consent to an extension.

It would be a potential violation of taxpayers' rights if the IRS did not notify taxpayers of their options when requesting assessment statute extensions. If taxpayers were not notified of their rights, extensions granted by taxpayers in these instances may not be valid. There were approximately 18,280 tax modules with statutes extended by the taxpayer's written consent that were recorded between April 1 and September 30, 2000. These tax modules included individual, corporate, partnership, employment tax, and other types of returns on the IRS' Masterfile[7] records. Based on our random sample, we estimate that the case files for approximately 460[8] taxpayer accounts nationwide do not contain the required documentation that the taxpayers were advised of these rights.

The date to complete corrective actions has been postponed from January 1, 2001, to January 1, 2002

In our FY 2000 review of assessment statute extensions, we identified about the same percentage of cases (5 percent) that had no documentation that taxpayers were advised of this right. Our recommendations included a requirement that examination group managers review case files for documentation that these rights were explained before approving the statute extension forms. The IRS agreed to

[7] The IRS database that maintains transactions or records of individual tax accounts.

[8] This estimate is based upon a 4.7 percent error rate, 90 percent confidence level, and a 2 percent precision rate.

take this corrective action by January 1, 2001; however, the IRS subsequently postponed the corrective action dates for all recommendations to January 1, 2002. The IRS advised us that the completion of the corrective actions was delayed due to resource limitations and conflicting priorities.

Procedures for documenting the advice of rights in case files vary among the business units

The IRM covering the examination of tax returns requires that when IRS employees request taxpayers to agree to extend the assessment statute, they must complete the following actions:

- Provide the taxpayer with an L-907 (maintaining a copy of the letter in the case file) and a Publication 1035 as an attachment.
- Document on a contact/activity record whether taxpayers were notified of their rights.

Although about 94 percent of the sample of 180 tax modules had some form of documentation of rights, not all case files had complete documentation.

- In 6 percent of the tax modules, there was no indication that the taxpayers were notified of their rights (previously mentioned on page 3).
- In 13 percent of the tax modules, a copy of an L-907 was not in the case file, although there was some documentation in the contact/activity record that taxpayers were notified of their rights.
- In 25 percent of the tax modules, there was no documentation that taxpayers were notified of their rights in the contact/activity record, although the case file had documentation of the L-907 or Publication 1035 being provided to the taxpayer.
- In 56 percent of the tax modules, the case file had complete documentation that taxpayers were advised of their rights.

Procedures for documenting advice of rights vary among the different business units. For example, managers in the Large and Mid-Size Business Division stated that they do not generally maintain the same detailed contact/activity records that are used in smaller audits. Appeals managers stated that they are not required to follow the IRM examination section for statute extensions and they do not have similar requirements in their IRM sections. Appeals procedures also differ with examination business units in that an Appeals Officer may sign a statute extension without manager approval, but an examiner may not.

In our FY 2000 review, we recommended that examination managers be required to confirm that advice of rights had been adequately documented in case files before approving assessment statute extensions. Since documentation procedures vary and some case files are voluminous, the IRS should consider having one location in all audit files for documentation of advice of rights to help ensure that this requirement is met. Requiring the cover letter (L-907 or L-967, "Letter Transmitting Consent Extending Period of Limitation" for Appeals) to be attached to the extension form would help managers to quickly confirm that the taxpayer has been advised of rights before the manager or Appeals Officer approves the extension.

The IRS is now collecting data to monitor compliance with RRA 98 § 3461(b)

In FY 2001, the IRS Examination Quality Measurement System (EQMS) started compiling data on compliance with RRA 98 § 3461(b). The IRS criteria used in these EQMS reviews is similar to the criteria used for this audit. The EQMS reviews case files to determine if there is either an L-907, a Publication 1035, or a written record of verbal advice of rights. These data should help the IRS to identify areas of concern and improvement trends. Requiring the cover letter to be attached to the extension form would also help in these quality reviews.

Recommendation

1. The Commissioners for each of the business units (Large and Mid-Size Business; Small Business/Self-Employed; Tax Exempt and Government Entities; Wage and Investment) and the Chief, Appeals, should require

that assessment statute extension cover letters (L-907 and L-967) confirming advice of rights be attached to statute extension forms when the extension is approved. The cover letter would then be filed together with the extension form directly behind the return, to make it easy to locate in the case file.

Management's Response: Management's response was due on September 14, 2001. As of September 19, 2001, management had not responded to the draft report.

Profiles of Assessment Statute Extension Requests

Taxpayers generally do not request that extensions be limited to specific issues

If an extension is not limited to specific issues, the IRS has the option to open any new audit issues during the extended period. However, taxpayers generally do not request this limitation. We identified language restricting the statute extensions to specific audit issues in only 8 of 180 tax modules (4 percent) reviewed. There was one other request by a taxpayer for restricted language in which the taxpayer later agreed to an extension that was not restricted to specific issues. Other than these, there were no other cases in our sample with documentation of requests by taxpayers to restrict statute extensions to specific issues.

Assessment statutes are often extended in order to allow taxpayers the time needed to appeal

In 73 of the 180 tax modules (41 percent) reviewed, the taxpayers agreed to the extension in order to allow time to appeal a proposed assessment. The IRM requires that the remaining time on the assessment statute of limitations must be at least 180 days in order to allow time to complete the appeals process.

The IRS does not generally request extensions for unlimited periods of time

The IRS may request that a taxpayer agree to extend an assessment statute for either an indefinite or a specific period of time. For indefinite extensions, the statute would expire after the IRS notifies the taxpayer of completion of the audit or after the taxpayer notifies the IRS of a revocation of the extension. Taxpayers can revoke an indefinite extension at any time. Once the extension is revoked, the IRS has 90 days to propose a deficiency.

While an audit is open, the IRS can identify assessment statutes which have been extended for an indefinite period by a code on the Audit Information Management System (AIMS).[9] Based on AIMS data for examinations started after January 1, 2000, and still open as of November 30, 2000, we estimate that, nationwide, there were 208 tax modules with assessment statute extensions for an indefinite period of time.

We reviewed a judgmental sample of 11 of the 208 indefinite statute extensions secured after January 1, 2000, in the former IRS district office locations we visited and determined that there was adequate justification for requesting indefinite extensions in these cases. These cases consisted of multi-year audits of large corporations or audits with complex issues.

Many taxpayers who agree to statute extensions have representatives and/or declared Powers of Attorney

In 118 (66 percent) of the 180 tax modules reviewed, we identified that the taxpayers made a declaration of representation and established Powers of Attorney (POA). A POA may be an attorney, an accountant, a tax return preparer, or other person authorized to represent the taxpayer in an IRS audit. Some managers in the Large and Mid-Size Business Division informed us that many of the large corporate taxpayers may not have a formal POA form on file with the IRS but do have representation because they have their own accountants and attorneys on staff to work on IRS audits. In general, representatives should be more familiar with the tax law and the taxpayers' rights regarding assessment statute extension requests than taxpayers that do not have representatives. However, just because the

[9] The IRS database that provides inventory and activity controls of active examination cases.

taxpayer has a representative, it does not relieve the IRS of the responsibility to advise the taxpayer, or the taxpayer's representative, of his or her rights when requesting extensions of the assessment statute of limitations.

Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives were to provide information regarding extensions of the assessment statute of limitations and to determine whether the Internal Revenue Service (IRS) was complying with requirements of RRA 98 Section (§) 3461(b) to provide taxpayers an explanation of their rights to decline to extend the assessment statute of limitations or to request that any extension be limited to a specific period of time or to specific audit issues. To accomplish our objectives, we performed the following tests:

I. Determined whether taxpayers were being advised of their rights related to requests to extend the assessment statute of limitations.

  A. Reviewed the Internal Revenue Manual, IRS memoranda, and IRS Counsel opinions and determined policies and procedures for processing requests to extend the assessment statute of limitations.

  B. Obtained the Fiscal Year (FY) 2000 (October 1, 1999, to September 30, 2000) Individual Masterfile[1] and Business Masterfile[2] databases to identify and review tax modules with adjustments to the assessment statute of limitations within the audit period from April 1, 2000, to September 30, 2000.

    1. Analyzed the databases to identify assessment statute adjustments that could have resulted from extensions by the written consent of taxpayers (Assessment statutes are often extended for reasons other than the taxpayer's written consent. For example, all cases having a statutory notice of deficiency (90-day letter) have the assessment statute extended for 150 days by law).

    2. Used two-stage attribute sampling to randomly select 10 former IRS district offices and randomly select approximately 32 tax modules per district office (a total of 322 tax modules) to review the case files. These samples were greater than needed in order to ensure that the number available for review would be sufficient for estimating the total error rate. Of the 322 tax modules selected, 180 cases were assessment statute extensions by written agreement from the taxpayer, 84 were not available for review, and 58 were assessment statute adjustments for a reason other than an extension by taxpayer agreement.

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[1] The IRS database that maintains transactions or records of individual tax accounts.

[2] The IRS database that consists of federal tax-related transaction and business accounts. These include employment taxes, income taxes on businesses, and excise taxes.

3. Reviewed 180 cases that were the result of an extension by taxpayer agreement to determine whether taxpayers were advised of their extension rights. Based upon a 90 percent confidence level, a 2 percent precision rate, and a 4.7 percent error rate, we estimated the total number of taxpayer case files without the required documentation.

C. Reviewed a judgmental sample of 11 of 208 extensions secured after January 1, 2000, and having extensions for an indefinite period of time to determine if the indefinite periods were appropriate and that the taxpayers were advised of rights.

D. Determined if the IRS completed corrective actions in response to the recommendations presented in the Treasury Inspector General for Tax Administration FY 2000 report.[3]

II. Determined the causes for the IRS to request extensions of the assessment statute.

A. Reviewed the 180 cases in which taxpayers agreed to the assessment statute extensions for documentation of the causes that the IRS needed to extend the assessment statute of limitations.

III. Determined whether limited-scope assessment statute extensions were appropriate and consistently allowed or disallowed.

A. Reviewed the 180 cases in which taxpayers agreed to the assessment statute extensions for documentation of taxpayer requests to limit extension to particular issues or particular time periods.

B. Determined whether IRS employees consistently allowed or disallowed limited-scope assessment statute extensions.

[3] *Information Provided to Taxpayers When Requesting Extensions of the Assessment Statute of Limitations Can Be Improved* (Reference Number 2000-10-142, dated September 2000).

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner, Large and Mid-Size Business Division LM
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Director, Legislative Affairs CL:LA

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights – Potential; 460 taxpayer accounts (862 tax modules) potentially affected (see page 3).

Methodology Used to Measure the Reported Benefit:
From the IRS' Individual Masterfile[1] and Business Masterfile[2] databases, we obtained computer extracts of tax modules with adjustments to the assessment statute of limitations during Fiscal Year (FY) 2000 (October 1, 1999, to September 30, 2000). These extracts contained records for 145,460 tax modules.

The IRS does not track assessment statute adjustments that were specifically due to the taxpayer's written consent. From the extract, we identified 23,787 assessment statute adjustments that could have resulted from extensions by the written consent of taxpayers during the period that we audited, April 1, 2000, to September 30, 2000.[3] Assessment statutes are often extended for reasons other than the taxpayer's written consent. For example, cases having a statutory notice of deficiency (90-day letter) have the assessment statute extended for 150 days by law. We identified these cases based upon the length of time of the assessment statute adjustment and tested a random sample of 124 cases to validate that cases excluded were not the result of extensions by the taxpayer's written consent.

We selected a sample of cases from the 23,787 cases to determine if taxpayers were advised of their rights to refuse or to limit the scope of the statute extension. We used a two-stage attribute sampling technique to randomly select 10 out of the 33 former IRS district offices and to randomly select approximately 32 tax modules per district office (a total of 322 tax modules). These samples were greater than needed in order to ensure that the number available for review were sufficient to estimate the total error rate. Of the 322 tax modules selected, 180 were assessment statute extensions by written agreement from the taxpayer, 84 were not available for

[1] The IRS database that maintains transactions or records of individual tax accounts.

[2] The IRS database that consists of federal tax-related transaction and business accounts. These include employment taxes, income taxes on businesses, and excise taxes.

[3] This does not include international accounts.

review, and 58 were assessment statute adjustments for a reason other than an extension by taxpayer agreement.

Based on the results of our sample, we estimated that 18,280[4] out of 23,787 modules were extended by the taxpayer's written consent. The 11 tax modules in the sample without adequate documentation resulted in an estimated error rate of 4.7 percent. The 4.7 percent error rate was calculated using two-stage sampling analysis and a weighted average[5] of the error rates found in each of the 10 sampled clusters. This resulted in an estimate of 862 tax modules (the population of 18,280 multiplied by the 4.7 percent error rate) that did not have adequate documentation of taxpayer rights. This estimate is based upon the 4.7 percent error rate, a 90 percent confidence level, and a 2 percent precision rate. Based upon the average number of tax modules per taxpayer account in our sampled population (23,787 modules for 12,691 taxpayer accounts equals 1.87 modules per taxpayer account), we estimate that 460 taxpayer accounts (862 tax modules divided by 1.87) did not have documentation that taxpayers were advised of their rights.

[4] This number is an estimate based upon the percentage of cases in our sample at each location (cluster) that were actually assessment statute extensions by the taxpayer's written consent.

[5] The total error rate for two-stage attribute sampling is based upon a weighted average of the error rates found in each cluster. The weighting is based upon the population, sample size, and error rate in each cluster.